Issue 2010-11
November 26, 2010

employee plans news

PROTECTING RETIREMENT BENEFITS THROUGH EDUCATING CUSTOMERS

Internal Revenue Service
Tax Exempt and Government
Entities Division

A Publication of Employee Plans

In-Plan Roth Rollovers

Guidance and Forms 1099-R and 8606 reporting instructions for retirement plan sponsors and participants

Funding Relief for Multiemployer Defined Benefit Plans

Notice 2010-83 provides funding relief for multiemployer plans under new Code §431(b)(8).

Governmental Retirement Plans- Determination Letters

Governmental retirement plans have until January 31, 2011, to file for a determination letter with the IRS.

Pre-Approved IRAs

Guidance on pre-approved and model IRAs, including information on optional amendments, procedures for applying for opinion letters and upcoming model IRAs

Form 5500 Notices Sent in Error Need a Response

Please respond to IRS CP 213 notices requesting missing information even if you have corrected the error with an amended return.

In-Plan Roth Rollovers - New Guidance and 2010 Forms 1099-R and 8606 Reporting Instructions

On November 26, 2010, the IRS issued Notice 2010-84, containing guidance for 401(k) and 403(b) plans about in-plan Roth rollovers - a feature that permits plan participants to roll over eligible rollover distributions (ERDs) made after September 27, 2010, from a non-Roth account into a designated Roth account in the same plan. A non-Roth account means any plan account that does not hold designated Roth contributions.

Eligible Participants

- Besides plan participants, surviving spouse beneficiaries and alternate payees who are current or former spouses are also eligible to do an in-plan Roth rollover.

Types of In-plan Roth Rollovers

- In-plan Roth direct rollover - when the plan trustee transfers an eligible rollover distribution from a participant's non-Roth account to the participant's designated Roth account in the same plan.
- In-plan Roth 60-day rollover - when the participant deposits an eligible rollover distribution within 60 days of receiving it from a non-Roth account into a designated Roth account in the same plan.

Plan Amendments

- 401(k) and 403(b) plans have extended deadlines to amend to allow 2010 in-plan Roth rollovers if the amendment's effective date is the date the plan first operated in accordance with that amendment.
    - 401(k) plans have until the later of the last day of the year in which the amendment is effective or December 31, 2011.
    - Safe harbor 401(k) plans have until the later of the day before the first day of the plan year in which the safe harbor plan provisions are effective or December 31, 2011.
    - 403(b) plans have until the later of the plan's remedial amendment period (described in Announcement 2009-89) or the last day of the first plan year in which the amendment is effective.
- A §457(b) government plan may adopt an amendment to include a designated Roth account after December 31, 2010, and then allow in-plan Roth rollovers.

Eligible Rollover Distributions

- Participants may only roll over eligible rollover distributions from a non-Roth account to a designated Roth account in the same plan.
- A plan can be amended to allow new in-service distributions from the plan's non-Roth accounts conditioned on the participant rolling over the distribution in an in-plan Roth direct rollover. However, the plan cannot impose this condition on any existing distribution options available under the plan.

In-Plan Roth Rollover Account

- A plan may have to hold in-plan Roth rollovers for a participant in a separate account maintained solely for these rolled over amounts.

In-Plan Roth Rollovers Not Treated as a Distribution

- A distribution rolled over as an in-plan Roth direct rollover is not treated as a distribution for the following purposes:
    - Transferring a plan loan to the designated Roth account without changing its repayment schedule;
    - Requiring spousal consent;

- Requiring a participant's consent before an immediate distribution of an accrued benefit of more than $5,000; and
- Eliminating a participant's right to optional forms of benefit.

Written Explanation (402(f) Notice)

If a plan offers in-plan Roth rollovers, it must include a description of this feature in the written explanation (402(f) Notice) the plan provides to participants who receive an eligible rollover distribution. Notice 2010-84 describes how a plan that uses the safe harbor explanations can revise them if it offers an in-plan Roth rollover option to participants.

Taxability and Withholding

- In-plan Roth rollovers are not subject to the 10% additional tax on early distributions under Code §72(t) and an in-plan Roth direct rollover is not subject to the mandatory 20% withholding under Code §3405(c). An individual who makes an in-plan Roth direct rollover may have to increase his or her federal income tax withholding or make estimated tax payments to avoid an underpayment of tax penalty.
- A special recapture rule applies when a plan distributes any part of the in-plan Roth rollover within a 5-taxable-year period, making the distribution subject to the 10% additional tax on early distributions under Code §72(t) unless an exception to this tax applies or the distribution is allocable to any nontaxable portion of the in-plan Roth rollover. The 5-taxable-year period begins January 1 of the year of the in-plan Roth rollover and ends on the last day of the fifth year of that period. This special recapture rule does not apply when the participant rolls over the distribution to another designated Roth account or to his or her Roth IRA but does apply to a subsequent distribution from the rolled over account or IRA within the 5-taxable-year period.
- Notice 2010-84 prescribes an ordering rule and an example involving a distribution from a participant's designated Roth account to which the participant had made an in-plan Roth rollover.

Special Rules for 2010 In-Plan Roth Rollovers

- The participant generally reports the taxable amount (fair market value of the distribution minus the employee's basis in the distribution) of an in-plan Roth rollover in the taxable year in which he or she receives the distribution. However, for in-plan Roth rollovers done in 2010, the participant:
  - reports half of the taxable amount in 2011 and the other half in 2012 (2-year income spread), or
  - elects to report the entire taxable amount in 2010.

If a participant elects to include the taxable amount in 2010, this election applies to all of his or her in-plan Roth rollovers in 2010 and he or she may not revoke the election after the due date (including extensions) of his or her 2010 tax return.

- In order for a participant to be eligible for the 2-year income spread, the distribution to be rolled over in an in-plan Roth rollover has to be made no later than December 31, 2010, and the plan must have a designated Roth account in place at the time the distribution is rolled over.
- Special income acceleration rules apply if the participant later receives a distribution of any amount of the taxable portion of the in-plan Roth rollover in 2010 or 2011 that wouldn't have been included in gross income until 2011 and 2012. Under these rules, the participant must increase gross income in the year of distribution by the amount of the distribution that the participant could have deferred to 2012. Notice 2010-84 has an example where a participant receives a distribution allocable to the taxable portion of an in-plan Roth rollover where such taxable portion has not yet been included in the participant's gross income.

No Recharacterization Rights

- Unlike a conversion or rollover to a Roth IRA, a participant may not recharacterize any amount of an in-plan Roth rollover.

Loans

- If an outstanding loan is part of in an in-plan Roth rollover, the taxable amount of the rollover is the balance of the loan.

Reporting 2010 In-plan Roth Rollovers

Form 1099-R Reporting

- Report 401(k) and 403(b) in-plan Roth direct rollovers on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*:
- Include the amount rolled over in box 1 (Gross distribution)
- Include the taxable amount rolled over in box 2a (Taxable amount)
- Don't check box 2b (Taxable amount not determined)
- Report the basis in the amount rolled over in box 5 (Employee contributions)
- Use distribution code "G" in box 7

Plans are not required to withhold 20% for an in-plan Roth direct rollover. The 10% additional tax on early distributions under Code §72(t) does not apply to any amount of an in-plan Roth rollover.

Plans must report any distributions made in 2010 from designated Roth accounts allocable to an in-plan Roth rollover on a separate Form 1099-R. Report the distribution as you would any other distribution from a designated Roth account (see Form 1099-R instructions). However, in the blank box to the left of box 10, enter the amount of the distribution allocable to the in-plan Roth rollover.

For additional information, please see the Changes to Current Tax Forms, Instructions, and Publications Web page.

Plan Participants - Form 8606 Reporting

Plan participants who make an in-plan Roth rollover in 2010 must:

- File Form 8606, *Nondeductible IRAs*, with their 2010 tax return
- Complete Form 8606, Part III, to report their in-plan Roth rollover
- Complete certain lines of Form 8606, Part IV, if they receive a distribution in 2010 of any amount of their in-plan Roth rollover
- Complete Form 8606, Part II, to report any amount converted from a non-Roth IRA to a Roth IRA in 2010
- File and complete a separate Form 8606, Part III, if they also rolled over amounts from a qualified retirement plan to a Roth IRA in 2010

View the proposed revisions to the 2010 Form 8606 on our Draft Tax Forms Web page.

Funding Relief for Multiemployer Defined Benefit Plans

On November 26, 2010, the IRS issued Notice 2010-83, which gives guidance on funding relief for multiemployer plans under new Code §431(b)(8), as added by the Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 (PRA 2010), §211(a)(2).

The funding relief consists of two parts:

1. under a special **amortization rule**, plans can set up a separate amortization base for the portion of the net experience loss attributable to the eligible net investment loss, to be amortized over the 29-plan-year period beginning with the recognition year. The portion of the net experience loss that is not attributable to the eligible net investment loss is amortized over 15 plan years, under Code §431(b)(2)(B)(iii); and

2. under a **special asset valuation rule**, plans can recognize eligible net investment losses in the actuarial value of plan assets over a period of up to 10 years (rather than the general five-year limit) and the actuarial value is subject to an 80-130% asset value corridor (rather than the general 80-120% corridor).

The notice addresses various actuarial calculations for PRA funding relief, such as the determination of:

- eligible net investment losses in general;
- eligible net investment losses if the net experience loss for the plan year is less than the amount attributable to the eligible net investment loss, or if there is an overall experience gain for the plan year; and
- the portion of the net experience gain or loss for a recognition year that is attributable to an eligible net investment loss.

Availability of Funding Relief

In order to get PRA funding relief, the plan must pass a solvency test and use the relief results in restrictions on benefit increases.

The notice requires the plan sponsor to decide to apply relief through its formal decision-making process and by the earlier of:

- the deadline for certification of the plan's funded status (i.e., endangered, critical or neither) for the 2011 plan year (March 30, 2011, in the case of a calendar year plan);
- the date of actual certification of the plan's status for the 2011 plan year (i.e., if the certification is made before the certification deadline); or
- June 30, 2011.

The plan must notify participants and beneficiaries of the plan's application of the special funding rules within 30 days after the deadline for the plan sponsor's formal decision to apply them.

Plan Status Recertification

If a plan decides to apply the special funding rules under Code §431(b)(8) after the certification of a plan's status under Code §432(b)(3) for a plan year, the special funding rules won't be reflected in the certification of the plan's status until the following plan year. However, the plan sponsor is permitted to request that the plan actuary redetermine the plan's status under Code §432(b)(3) for a plan year, taking into account the application of the special funding rules, provided certain conditions are met.

Form 5500 and Schedule MB Reporting

Plan sponsors who want to apply the special funding relief are permitted, but not required, to file amended Form 5500s. Instead, a plan sponsor who did not apply the special funding relief on its filed Form 5500 should include an attachment to Schedule MB for the subsequent plan year showing how the information reported would have differed if it used the special funding rules. A plan sponsor who already applied the special funding relief on its filed Form 5500 should include an attachment to its Schedule MB for the subsequent plan year showing how its calculations were different from the calculations required by this notice.

Governmental Plan Determination Letters Under Cycle E

Qualified governmental plans (Code §401(a) governmental plans) that would like to have the IRS review the form of their plan document to ensure compliance with the applicable tax qualification requirements may file for a determination letter during Cycle E until January 31, 2011. Under Revenue Procedure 2007-44, the remedial amendment cycle for a governmental plan that is not a pre-approved plan is Cycle C. More than 1700 governmental plan sponsors submitted their plans for a determination letter under Cycle C, which closed on January 31 2009.

Although not mandatory, there are a number of advantages to filing a determination letter request. This article discusses the special relief that allows Code §401(a) governmental plans to file for a determination letter under the current Cycle E, as well as the benefits and the scope of a determination letter, and some of the specific issues we have encountered in reviewing Cycle C applications.

We also invite you to subscribe to *Governmental Plans Updates* and receive free periodic e-mail updates about recent developments for governmental plans.

Special Relief for Filing a Determination Letter Request

Pursuant to special relief provided by Revenue Procedure 2009-36, Code §401(a) governmental plans have a one-time opportunity to submit determination letter applications during the current Cycle E, which opened February 1, 2010, and does not close until January 31, 2011. Any Code §401(a) governmental plans that do not file by January 31, 2011, will not have another opportunity to file "on-cycle" until the next Cycle C, which does not open until February 1, 2013. The November 8, 2008 Special Edition of *Employee Plans News* discussed the availability of Cycle E submissions to governmental plan sponsors.

Why File for a Determination Letter?

Although submitting a request for a determination letter is voluntary, there are compelling reasons for requesting a favorable determination letter, including:

I. minimizing the risk that a plan will be disqualified on audit because the form of the plan document does not satisfy the
applicable tax-qualification requirements; and

II. the availability of certain self-correction programs under the Employee Plans Compliance Resolution System (EPCRS).

I. Minimizing the Risk of Plan Disqualification on Audit

A favorable determination letter indicates that, in the opinion of the IRS, the terms of the plan (i.e., the form of the document) conform to the tax-qualification requirements contained in the Internal Revenue Code (Code). Accordingly, a favorable determination letter provides a plan sponsor with protection from the risk that the IRS, upon audit of the plan, will determine that the written terms of the plan for the period covered by the determination letter do not satisfy the applicable tax qualification requirements. Without the benefit of the favorable determination letter:

- The plan could be retroactively disqualified back to the date of the defective amendment(s) and eliminate the tax benefits applicable to tax-qualified plans for all affected years; or
- The plan sponsor would have to enter into a special closing agreement with the IRS and agree to pay relatively expensive sanctions.

It should be noted, however, that to be a qualified plan under Code §401(a), a plan must satisfy the qualification requirements in both form and operation. A favorable determination letter generally does not cover operational issues. For additional information, please see Publication 794, *Favorable Determination Letter*.

II. Taking Advantage of EPCRS Programs

EPCRS permits plan sponsors to correct certain compliance failures on a voluntary basis that might otherwise result in plan disqualification or other sanctions. In many cases, these self or voluntary correction programs require the payment of no fees or sanctions, or only a relatively modest fee. However, a favorable

determination letter may be a prerequisite for taking advantage of certain correction programs under EPCRS (*for example*, to self-correct a significant operational failure under the Self-Correction Program (SCP)).

Scope of a Determination Letter

As noted above, a determination letter generally expresses an opinion on the form, not the operation, of the plan. Additionally, the determination letter covers the new items that apply to Code §401(a) governmental plans listed on the applicable Cumulative List of Changes in Plan Qualification Requirements (Cumulative List), which is published annually as a Notice around mid-November of each year. A Code §401(a) governmental plan must ensure that its plan document contains all of the applicable items listed on the Cumulative List prior to filing the determination letter application.

A plan sponsor may not rely on a determination letter for any qualification changes that become effective, any guidance published, or any statutes enacted, after the issuance of the latest Cumulative List or any changes in the law first listed on a subsequent Cumulative List.

A plan sponsor may also not rely on a determination letter as to certain specified issues or plan features. The recently updated Publication 794 identifies some of those items most relevant to Code §401(a) governmental plans including:

- **Whether an Entity Is Eligible To Sponsor a Governmental Plan**

  A Code §401(a) governmental plan may only be established and maintained by a governmental entity. A favorable determination letter does not address, and cannot be relied upon with respect to, the issue of whether an employer is eligible to sponsor a governmental plan. Rather, the plan sponsor must represent in its application for a determination letter that it is a governmental entity eligible to sponsor a governmental plan. If the IRS subsequently determines that there is a misstatement or omission of material facts in the application for a determination letter (for example, if the application indicates that the plan is a governmental plan, and it is not, or that the plan sponsor is a governmental entity, and it is not), the determination letter cannot be relied upon.

- **Employer Pick-up Arrangements**

  If certain requirements are met, Code §414(h)(2) permits governmental plan sponsors to *pick up* contributions that would otherwise be employee contributions under the plan. Such pick-up contributions are treated as employer contributions for federal income tax purposes. A favorable determination letter does not express an opinion regarding whether a *pick-up* arrangement satisfies the requirements of Code §414(h)(2). A plan sponsor that would like a ruling on this issue may request a private letter ruling (PLR) under Revenue Procedure 2010-4 (or any successor procedure).

- **Excess Benefit Arrangements**

  If certain requirements are met, Code §415(m) states that benefits provided under a qualified *excess benefit arrangement* are not taken into account in determining whether a governmental plan satisfies Code §415 limitations on contributions and benefits. An *excess benefit arrangement* is generally a program maintained by a governmental employer in order to provide benefits for certain employees in excess of the Code §415 limitations. A favorable determination letter does not express an opinion regarding whether an arrangement that purports to be an excess benefit arrangement meets the requirements of Code §415(m). A plan sponsor that would like a ruling on this issue may request a PLR under Revenue Procedure 2010-4 (or any successor procedure).

Common Governmental Plan Issues and Questions

In reviewing the Cycle C determination letter applications filed by Code §401(a) governmental plans, certain common issues or questions have been identified. Following is a short discussion regarding some of these topics that may prove helpful to plan sponsors preparing Cycle E determination letter applications for Code §401(a) governmental plans.

1. Section 415 Limitations on Contributions and Benefits

As stated earlier, a plan sponsor must update the plan for all of the statutory, regulatory and other changes identified in the applicable Cumulative List before applying for a determination letter. For example, among the changes listed in the Cumulative List for Cycle E are those applicable to the limitations on contributions

and benefits under Code §415. Final Code §415 regulations were issued in 2007. Plan documents should accurately reflect these new rules, including the definition of *compensation* for purposes of Code §415, as of the applicable effective dates.

2. Normal Retirement Age and Vesting - Profit-Sharing Plans

A qualified profit-sharing plan that is a Code §401(a) governmental plan must generally provide for:

- Full vesting of an employee's account balance upon the attainment of a stated age, and
- The employee's right to a distribution of his or her account balance at that time.

More information regarding these requirements may be found in Revenue Ruling 66-11, 1966-1 C.B. 71.

While it is best to have plan language that explicitly satisfies the above requirements, the IRS will treat a profit-sharing plan that is a Code §401(a) governmental plan as meeting the requirements if the plan provides for:

- full and immediate vesting, and
- distribution of benefits upon termination of employment.

3. Plans with Multiple Benefit Structures

Code §401(a) provides that the key elements of how benefits are determined, such as contribution rates, allocation formulas, benefit formulas or actuarial assumptions, must be *definitely determinable* under the written terms of the plan. A plan provision that simply provides that a board of trustees or other person will from time to time determine such key elements violates the definitely determinable requirement of Code §401(a). A governmental plan sponsor whose plan provides for multiple benefit structures that are subject to change due to legislative or administrative developments might consider one of the following strategies:

- Attach an appendix to the plan document specifying any information that varies from one group of participants to another. The information stated in the appendix should be adopted prospectively, and not be subject to the discretion of a board of trustees or other person. The appropriate section of the plan document should reference the appendix. The plan sponsor may timely amend the appendix as circumstances require.
- The relevant plan provisions must be appropriately and timely amended and maintained in a manner that satisfies the definitely determinable requirement. For this purpose, the plan document may incorporate collective bargaining agreements or other relevant documents by reference, but should affix the applicable portions of such documents to the plan document.
- Each contributing employer might separately adopt a plan document that satisfies the definitely determinable requirement.

4. Plans That Provide for Refunds of Employer Contributions

A Code §401(a) plan must have a provision stating that it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries, for any part of the corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of employees and their beneficiaries. Generally, a qualified plan may not permit reversions or refunds of employer contributions. However, there are some exceptions. A defined benefit plan may allow an employer to reserve the right to recover at termination of the plan any balance remaining in the trust that is due to *erroneous actuarial computations*. In addition, Revenue Ruling 91-4, 1991-1 CB 57, provides that, in accordance with §403(c)(2) of the Employee Retirement Income Security Act of 1974, as amended (ERISA), refunds of employer contributions are permitted under certain very limited circumstances relating to mistakes of fact, initial qualification of the plan and disallowed deductions. A Code §401(a) governmental plan must explicitly permit a reversion or refund of employer contributions in order for any such reversion or refund to be permitted.

5. Cross-referencing Plan Sections

Some plan document provisions satisfy statutory or regulatory requirements by cross-referencing other plan provisions. When a plan sponsor restates a plan document, the numbering of plan provisions may change such that the cross-referencing in the document is no longer accurate. When the plan sponsor submits the plan for a determination letter, any cross-referencing inaccuracies may unnecessarily slow down the processing of the application. A plan sponsor's careful review of the entire plan document before submission will reduce the number of these errors and accelerate the processing of the application.

More Information

Employee Plans is interested in interacting with the governmental plan community in order to promote compliance with the qualification rules that apply to Code §401(a) governmental plans. You may submit specific questions or comments to our dedicated e-mail address: governmentalplansdialogue@irs.gov. Please regularly visit the governmental plan Web pages and subscribe to *Governmental Plans Updates* to receive free e-mail updates about recent developments for governmental plans.

Pre-Approved IRAs - New Guidance

The IRS released Revenue Procedure 2010-48 on November 23, 2010, providing guidance for drafters and users of pre-approved IRAs. It includes information on when prototype IRA sponsors must submit documents to the IRS for an opinion letter and how some sponsors may pay less in user fees by using a single annuity endorsement with multiple contracts. The revenue procedure also includes guidance for IRS's model IRA users.

Prototype IRAs

- As stated in the revenue procedure, prototype IRAs do not need to amend for various law changes since 2002 for the trustee, custodian or issuer to take advantage of them. These "statutory changes" are listed in the revenue procedure.
- A prototype IRA that does amend to incorporate the statutory changes may continue to rely on its favorable opinion letter.
- A prototype sponsor may apply for an IRS opinion letter at any time, including after it amends solely to incorporate the statutory changes. The sponsor must submit the IRA document with Form 5306, *Application for Approval of Prototype or Employer Sponsored Individual Retirement Arrangement (IRA)*.
- To receive a favorable opinion letter, prototype IRAs must include every applicable issue listed in the Listing of Required Modifications (LRMs). Sponsors are encouraged to use the LRM language.
- Prototype sponsors of individual retirement annuities that use one IRA endorsement with one or more annuity contracts may submit only the IRA endorsement (and not the contracts) for approval when applying for an opinion letter. If the IRS approves the application, it will issue a favorable opinion letter to the sponsor referencing the IRA endorsement. This change reduces sponsor user fees and the number of opinion letters the IRS issues.
- Form 5306 includes a checkbox to identify a dual-purpose IRA application - in situations when an opinion letter is for a prototype document designed to be used as either a traditional IRA or a Roth IRA.

Model IRAs

Model IRAs do not need to amend for the statutory changes. The IRS expects to issue new model amendments for:

- SIMPLE individual retirement annuity; and
- traditional individual retirement annuity.

Although not required, the IRS recommends that the plan sponsor adopt the model's latest form once these are available.

Form 5500 Series - CP 213 Proposed Penalty Notice

If you believe you received a CP 213, Proposed Penalty Notice, in error, please respond to the notice within 30 days of receipt. In your response, be certain to submit:

1. A copy of the CP 213 Notice,
2. Any appropriate supporting documents, and
3. Evidence that the return was timely filed or a reasonable cause statement, **or**
4. Evidence that the return was corrected with an amended return.

Please send your responses to the following address:

Ogden Accounts Management Center
EP Accounts Unit, Mail Stop 6270
Ogden, UT 84201

We recommend you send your responses by certified mail or a traceable private delivery service.

For additional information, please review our frequently asked questions on CP 213 Notices.